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No. 227.

IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1947.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOSEPH SUNNEN,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF FOR THE RESPONDENT.

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INDEX.

	Page
Statement of Case	1
Questions Presented	3
Summary of Argument	4
Argument	9
I. The Income in Question Is Not Taxable to the Assignor of the Income-Producing Property but to the Assignee	9
A. The Decision of the Tax Court in the Estate of J. G. Dodson v. Commissioner, 1 T. C. 416, Is Not Controlling	10
B. Assignment of Income or Income Producing Property	18
C. The Clifford Doctrine Is Not Applicable	23
D. Earned Income	31
E. Term of Royalty Contracts	33
F. Dobson v. Commissioner, 320 U. S. 489	34
II. The Doctrine of Res Judicata, or the Doctrine of Stare Decisis, Should Be Applied	35
A. 1937 Cylinder Grinder Royalties	35
B. Other Royalties	36
III. The Petitioner Did Not Assess the Deficiencies for 1937 and 1938 Within the Time Prescribed by Law	39
Conclusion	40
Appendix	43

CITATIONS.

Cases:

Abercrombie, J. S. Co., v. Commissioner, 7 T. C. 120, (affd. 5 Cir., 162 Fed. 2d 338. 1947, C. C. H. Standard Fed. Tax Rep., Vol. 4, Par. 9301, decided 6/25/47.. 23
Allen v. First Natl. Bank, 5 Cir., 157 Fed. 2d 592..... 21
American Mutual Liability Ins. Co. of Boston v. Duesenberg, 14 N. E. 2d 919, 16 N. E. 2d 698, 117 A. L. R. 1293..... 39
Ashforth v. Commissioner, 26 B. T. A. 1188 and G. C. M. 11,640, XII—1 C. B. 144..... 16
Backus, Estate of Standish, v. Commissioner, 6 T. C. 1036, C. C. H. Dec. 15,142 29
Bear Gulch Water Co. v. Commissioner, 9 Cir., 116 Fed. 2d 975 25
Betts, Commissioner v., 7 Cir., 123 Fed. 2d 534.....29, 30
Blair v. Commissioner, 300 U. S. 5.....5, 17, 20, 24
Blair, Commissioner v., 60 Fed. 2d 340..... 18
Blair v. Commissioner, 31 B. T. A. 1182..... 18
Blair v. Commissioner, 18 B. T. A. 69..... 18
Branch, Commissioner v., 1 Cir., 114 Fed. 2d 985....29, 30
Buffington v. South Missouri Land Co., 25 Mo. App. 492 13
Burrows v. Commissioner, T. C. Memo Dec. Dkt. 109537, entered 6/30/43, 2 T. C. M. par. 13,350 M, 1943, P-H T. C. Memo Dec. par. 43338.....39, 40
Busch v. Commissioner, 8 Cir., 148 Fed. 2d 798..... 25
Canfield, C. L., v. Commissioner, T. C. 944, decided 10/11/46, acquiesced I. R. B. 1947-2, p. 1, C. C. H. Dec. 15,414 & I. T. 3,845, par. 3 (b) 1947-7-12, 515, p. 2, 474 C. C. H. par. 6,140, p. 10189..... 32
City of Aurora v. West, 74 U. S. (7 Wall.) 82..... 37
Commissioner—See Name of Taxpayer.
Conant v. Commissioner, 7 T. C. 453..... 25
Copland v. Commissioner, 7 Cir., 41 Fed. 2d 501..... 18

Corliss v. Bowers, 281 U. S. 376 ..... 4, 36
Corning v. Commissioner, 6 Cir., 104 Fed. 2d 329 29
Cushman v. Commissioner, 2 Cir., 153 Fed. 2d 510 30
Dobson v. Commissioner, 320 U. S. 489 (rehearing denied 321 U. S. 231) 10, 16
Dodson, Estate of J. G., v. Commissioner, 1 T. C. 416 ..... 10, 16
Easton v. Commissioner, T. C. Memo Op. Dkt. No. 110,974, entered 2/5/43, 1 T. C. M. par. 12,963M, 1943 P-H. T. C. Memo Dec. par. 43,063 39
Eisner v. Macomber, 252 U. S. 189 17
Emery v. Commissioner, 1 Cir., 156 Fed. 2d 728 25
Faber v. U. S., 1 Fed. Supp. 859 16
Field v. Commissioner, 2 Cir., 42 Fed. 2d 820 ..... 18, 20
Flarsheim v. U. S., 156 Fed. 2d 105 15
Fox v. Commissioner, 37 B. T. A. 271 ..... 21, 25
Friedman v. Commissioner, 45 B. T. A. 976, affd. 4 Cir., 130 Fed. 2d 305 21
Funk, E. M., v. Commissioner, 7 T. C. 890, C. C. H. Dec. No. 15,397 21
Funk, W. J. v. Commissioner, 3 T. C. M. 100 (C. C. H. Dec. No. 13,727M, 1947 P-H T. C. Memo Dec. par. 44,030) 16, 21, 25
Gray, P. N. Co., Inc., v. Valliotis, C. A., 276 Fed. 565, affd.: 293 Fed. 1018 12
Greenspun, Commissioner v., 5 Cir., 156 Fed. 2d 917 25
Hall v. Burnett, App. D. C., 54 Fed. 2d 443, cert. den. 285 U. S. 552 20
Harrison v. Schaffner, 312 U. S. 579 ..... 23, 35, 36
Helvering v. Clifford, 309 U. S. 331 ..... 6, 23, 24, 31, 35
Helvering v. Eubank, 311 U. S. 122 ..... 23, 35
Helvering v. Horst, 311 U. S. 112 ..... 5, 6, 22, 23, 35
Helvering v. Seatree, App. D. C., 72 Fed. 2d 67 20
Helvering v. Stuart, 317 U. S. 154 ..... 17, 36
Hoeper v. Tax Commissioner, 284 U. S. 206 30
Houser v. Richardson, 90 Mo. App. 134 ..... 12, 13

Jergens v. Commissioner, 5 Cir., 136 Fed. 2d 497..... 25
Jones v. Norris, 10 Cir., 122 Fed. 2d 6..... 30
Katz, Commissioner v., 7 Cir., 139 Fed. 2d 107..... 29
Langley v. Commissioner, 61 Fed. 2d 796..... 16
Last Chance Mining Co. v. Tyler Mining Co., 157 U. S. 683..... 38
Leahy v. Dugdale, 41 Mo. 517..... 13
Lewis v. White, 56 Fed. 2d 390..... 16
Leydig v. Commissioner, 15 B. T. A. 124, affd. 10 Cir., 43 Fed. 2d 494..... 18
Lilienfeld v. Commissioner, 35 B. T. A. 396 (acquiesced in by Com. 1937—1 C. B. 15)..... 20
Lord v. Schamloeffel, 50 Mo. App. 360..... 13
Lowery v. Helvering, 2 Cir., 70 Fed. 2d 713.....18, 20
Lucas v. Earl, 281 U. S. 111.....7, 31
Lum v. Commissioner, 3 Cir., 147 Fed. 2d 356.....20, 23
Lusthaus v. Commissioner, 327 U. S. 293.....7, 31, 32, 33
Mallinckrodt v. Nunan, 8 Cir., 146 Fed. 2d 1..... 25
Moline Properties, Inc., v. Commissioner, 319 U. S. 436.....25, 29
Montgomery, Commissioner v., 5 Cir., 144 Fed. 2d 313.....21, 23, 25, 37
Montgomery v. Thomas, 5 Cir., 146 Fed. 2d 76.....21, 37
Nelson v. Ferguson, 3 Cir., 56 Fed. 2d 121, cert. den. 286 U. S. 565.....18, 20
Northwestern Mutual Life Ins. Co. v. Wright et al., 153 Wisc. 252, 140 N. W. 1078, American Annotated cases 1914 D, page 697..... 38
O'Donnell, Commissioner v., 9 Cir., 90 Fed. 2d 907, rev'd 303 U. S. 370..... 20
Pearce v. Commissioner, 315 U. S. 543.....23, 36
Pepper v. Litton, 308 U. S. 295..... 14
Porter Royalty Pool, Inc., v. Commissioner, 7 T. C. 685, C. C. H. Dec. No. 15,362.....21, 23

Ray, Rose L. v. Commissioner, 1941 P-H. B. T. A. Memo Dec. par. 41,325, C. C. H. Dec. No. 11,874a, B. T. A. Dkt. No. 101, 315, decided 6/26/41.....20, 34
Reinecke v. Northern Trust Co., 278 U. S. 339..... 29
Reis v. Commissioner, 1 T. C. 9..... 40
Richardson v. Commissioner, 2 Cir., 121 Fed. 2d 1, cert. den. 314 U. S. 684..... 25
Ross, Commissioner v., 6 Cir., 83 Fed. 2d 18..... 20
Ross, Estate of W. L. v. Commissioner, T. C. Memo Opinion, 2 T. C. M. 573, C. C. H. Dec. No. 13,416M... 21
Schreiber v. Commissioner, 6 T. C. 707, C. C. H. Dec. No. 15,076, affd. 160 Fed. 2d 108..... 32
Shanley v. Bowers, 2 Cir., 81 Fed. 2d 13.....20, 29
Smith et al., Extrs. v. Commissioner, 25 B. T. A. 291 18
Strauss v. Commissioner, 8 T. C. 121, C. C. H. Dec. No. 15,787, decided 5/15/47..... 20
Swartz, Edward G. Inc. v. Commissioner, 5 Cir., 69 Fed. 2d 633.....18, 23, 25
Sunnen v. Commissioner, 6 T. C. 431, rev'd 161 Fed. 2d 171..... 20
Suhr v. Commissioner, 6 Cir., 126 Fed. 2d 283..... 30
Timken, Estate of H. H. v. Commissioner, 47 B. T. A. 494, affd. 6 Cir., 141 Fed. 2d 625..... 20
Tower, Commissioner v., 327 U. S. 280.....7, 31, 32
U. S. v. Morss, 1 Cir., 159 Fed. 2d 142.....24, 30
Wachovia Bank & Trust Co. Trustees et al. v. Commissioner, 3 T. C. M. 595, C. C. H. Dec. No. 14,001M, 1944 P. H. T. C. Memo Dec. par. 44,217..... 26
Wheelock v. Commissioner, 7 T. C. 98, C. C. H. Dec. No. 15,216.....21, 25, 26, 28, 29
Wilcox, Commissioner v., 327 U. S. 404.....5, 16, 28, 30

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Reg. 111, Sec. 29.22(a)-22, 471 C. C. H. Par. 86B.... 25

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14 American Jurisprudence, p. 283..... 37
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Sec. 275 (a), Rev. Act 1936, 26 U. S. C. A., p. 918..3, 40, 43
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Sec. 275 (c), Rev. Act 1936, 26 U. S. C. A., p. 919....39, 43
Sec. 275 (c), Rev. Act 1938, 26 U. S. C. A., p. 1108...39, 44

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF FOR THE RESPONDENT.

I.

STATEMENT OF THE CASE.

Petitioner's statement contains no reference to the following facts which we deem pertinent:

The directors of Sunnen Products Company (except Joseph Sunnen), authorized the officers of the company

to enter into all royalty-license agreements involved in this case (R. 31).

On June 29, 1935 the Board of Tax Appeals held that Mr. Sunnen was not liable for income taxes on cylinder grinder royalties paid by Sunnen Products Company to Mrs. Sunnen during 1929, 1930 and 1931. In its decision the Board pointed out that the cylinder grinder royalty contract was an assignable property right, that the assignment by Mr. Sunnen of all of his right, title, and interest in and to that contract to Mrs. Sunnen vested title to the income-producing property in her, and that the royalty contract, and not Mr. Sunnen, produced the royalty income (R. 53-60).

This decision was rendered prior to the assignments by Mr. Sunnen of the renewal cylinder grinder royalty contract, and the assignment by him of all of his interest in the crank shaft grinder royalty contract.

The manufacture and sale by Sunnen Products Company of the patented cylinder grinder, pin-hole grinder, and two crank shaft grinders, pursuant to the royalty-license agreements executed by it and Mr. Sunnen, constituted more than half of the business of that company (R. 32).

The company employed from 90 to 220 persons, and paid them wages varying from approximately $189,000.00 per year to approximately $372,000.00 per year (R. 32).

The company owed its creditors amounts varying from approximately $123,000.00 to $574,000.00 (R. 32).

Mrs. Sunnen possessed a large independent fortune (R. 52).

Judge Van Fossan of the Tax Court, who heard the case at bar, dissented from the opinion of the majority of the court (R. 72).

II.

QUESTIONS PRESENTED.

Since the record contains no evidence of Mr. Sunnen's motive for assigning the royalty contracts to his wife, we deem it improper for the petitioner, on page 2 of his brief, to infer that Mr. Sunnen made such assignments to avoid income taxes.

It is our opinion, therefore, that the questions presented in this case should be stated as follows:

1. Whether a majority stockholder of a corporation, who owns patent applications and patents, who then enters into royalty-license contracts with the corporation for the manufacture and sale of the inventions, who subsequently assigns all of his right, title, and interest in and to such contracts to a minority stockholder of the corporation, and who thereafter notifies the corporation of such assignments, is taxable upon the royalties later paid by the corporation to the assignee.

2. Whether the decision rendered by the Board of Tax Appeals in 1935 forms the basis of applying the doctrine of res adjudicata, or the doctrine of stare decisis, as to (a) cylinder grinder royalties paid to Mrs. Sunnen in 1937 under the same contract and assignment involved in Mr. Sunnen's prior Board of Tax Appeals decision and (b) cylinder grinder and other royalties paid to Mrs. Sunnen, during the period 1937-41, both inclusive, under royalty agreements and assignments similar in all material respects to the instruments involved in Mr. Sunnen's Board of Tax Appeals decision.

3. Whether or not the petitioner determined the deficiencies for 1937 and 1938 within the time prescribed by Sec. 275 (a), Revenue Acts of 1936 and 1938 (26 U. S. C. A., "Internal Revenue Acts," pp. 918, 1108), as extended by consents executed by the parties (R. 46-50).

III.

SUMMARY OF ARGUMENT.

I. The petitioner contends that, since Mr. Sunnen owned a majority of the stock of Sunnen Products Company, he could elect directors of the company, cause such directors to vote to cancel the royalty contracts previously executed by him and the company and assigned by him to his wife, and thus terminate the receipt of the royalties by her. Such power, the petitioner alleges, was equivalent to unilateral action on the part of Mr. Sunnen. If the petitioner's view is sound—if these royalties were thus subject to Mr. Sunnen's unfettered command—he should prevail upon the authority of *Corliss v. Bowers*, 281 U. S. 376. However, we contend that after Mr. Sunnen assigned the royalty contracts to his wife, and notified the company of such assignments, she, as assignee, under generally recognized principles of the law of assignments, could protect herself by legal action against any act of dominion by Mr. Sunnen over the contracts tending to deprive her of her rights, and could protect herself against any collusive action by him and the company tending to defeat her rights. We contend, further, that as Mrs. Sunnen was a substantial minority stockholder of the company when the royalty contracts were assigned to her, she could, as such stockholder, and by appeal to courts of law or equity, prevent Mr. Sunnen, as majority stockholder, from taking any action which was not inherently fair to the company and to Mrs. Sunnen and the other minority stockholders, and which was not in accordance with the standards of common decency and honesty. She could prevent him from doing anything indirectly through the corporation which he could not do directly. As majority stockholder Mr. Sunnen had no greater rights to the property of the company than Mrs. Sunnen and other minority stockholders. Therefore, if

Mr. Sunnen had sought to force the company to cancel the royalty contracts, which were the source of over half of its profitable business, or if he had sought to force the company to cease manufacturing under such contracts upon his promise to grant other licenses to the company in consideration of royalties payable to him, instead of to his wife, she could easily have blocked his action and protected her adverse interest. Mr. Sunnen's control was definitely less than that of the embezzler, Wilcox, involved in *Commissioner v. Wilcox*, 327 U. S. 404; and yet this court refused to tax Wilcox on sums embezzled by him because he, like Mr. Sunnen, had and could have no bona fide legal or equitable claim to the funds involved. Mr. Sunnen could have received no gain or profit from arbitrarily and wrongfully forcing the company to cancel the royalty contracts. The company could not, in good faith, cancel the contracts unless the manufacture and sale of these grinding machines was unprofitable to it; and Mr. Sunnen alone could not cause such manufacture and sale to be profitable or unprofitable. *Blair v. Commissioner*, 300 U. S. 5, governs this case.

To buttress his argument the petitioner claims that the underlying patents which Mr. Sunnen continued to own, and not the royalty contracts which he assigned to his wife, produced the royalty income here involved. He cites no authority for this proposition. This argument was rejected upon ample authority by the Board of Tax Appeals in a prior case involving Mr. Sunnen and by the Circuit Court of Appeals in the case at bar. Even the Tax Court in the case at bar did not adopt this contention. Moreover, the petitioner's argument conflicts with numerous decisions, never repudiated by this court, which clearly hold that contracts calling for the payment of income produce such income. The royalty contracts here involved are analogous to leases, and in *Helvering v. Horst*, 311 U. S.,

at p. 119, this court pointed out that rent from a lease is not income of a donor after he has made a gift of the lease. In addition, to hold that the patents, and not the royalty contracts, produced the royalties would lead to absurd tax results.

The petitioner further contends that Mr. Sunnen's control over the patents, and his power as majority stockholder of the company, brings his case within the ambit of *Helvering v. Clifford*, 309 U. S. 331. We contend otherwise. No trust is here involved. A regularly organized and operated business corporation is not a trust. Mr. Sunnen's rights do not coincide substantially with the normal concepts of full ownership. Mrs. Sunnen acquired, by virtue of the assignments, rights of far greater magnitude than those of her husband. Her rights were not insignificant. Mrs. Sunnen acquired full right to sell, pledge, or give away the royalty contracts—rights which Mrs. Clifford did not have. Such rights, under the petitioner's own regulations, usually cause the Clifford doctrine to be applied to tax the donee, not the donor. Unlike the Clifford case, the case at bar involves no reverter to the grantor, and no "short-term" arrangement. The petitioner's argument that Mr. Sunnen could license competitors of the company, and thus diminish his wife's royalties, is pure speculation. The petitioner pitches his case on an alleged power of Mr. Sunnen to misappropriate his wife's money, in violation of all standards of common decency and honesty. No decision should be based on possible fraud. Taxation should be upon a basis more stable than power of a taxpayer to sabotage a family company, or to make or break the business. Mr. Sunnen's alleged power to manage such business is not the control to which the Clifford case refers. The Clifford case does not merge the separate legal personality of a wife, espe-

cially when her property rights over the property involved are of greater magnitude than the rights of her husband. Every possible argument for applying the Clifford case to justify taxing these royalties to Mr. Sunnen, can be repeated with greater force as a reason for taxing them to Mrs. Sunnen.

The petitioner appears to contend also, and rather inconsistently, that these royalties were income earned by Mr. Sunnen. This view is clearly erroneous. Customers of the company bought and paid for grinding machines and not services of Mr. Sunnen. *Lucas v. Earl*, 281 U. S. 111; *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293, are readily distinguishable.

II. The petitioner opposes, and we urge, that the doctrine of res judicata, or the doctrine of stare decisis, is applicable. The same parties, and the same questions, were involved in Mr. Sunnen's prior case, wherein the Board of Tax Appeals held Mr. Sunnen not to be liable for cylinder grinder royalties paid to his wife in 1929, 1930 and 1931. The years here involved are 1937-41, both inclusive. As to the cylinder grinder royalties paid in 1937 under the same royalty contract which was involved in the prior case, our views prevailed in the case at bar before the Tax Court, and the Circuit Court of Appeals. The Tax Court rejected our views as to royalties paid in 1938 and thereafter under a renewal of the aforesaid cylinder grinder royalty contract, and as to other royalties paid under royalty contracts similar in all material respects to the original cylinder grinder royalty contract which was involved in Mr. Sunnen's prior case. We respectfully contend that as to these other royalties the Tax Court in the case at bar unduly stressed the evidence and ignored the applicable and settled legal principle established by the Board of Tax Appeals in Mr. Sunnen's prior decision.

III. The burden of proof, as to Mr. Sunnen's liability for income taxes on royalties paid in 1937 and 1938, must be borne by the petitioner. If he has not borne such burden, his determination of the deficiencies for those years was made after the expiration of the applicable statutes of limitation. If he has borne such burden, this question should be ruled against us. If we are right on the merits of the case, this point should be ruled against the petitioner.

ARGUMENT.

I.

THE INCOME IN QUESTION IS NOT TAXABLE TO THE ASSIGNOR OF THE INCOME-PRODUCING PROPERTY, BUT TO THE ASSIGNEE.

Mr. Sunnen invented certain grinding machines and subsequently applied for patents thereon. After making such applications, and before patents were issued, he entered into royalty-license agreements with Sunnen Products Company. These agreements authorized the company to manufacture and sell the grinding machines in the United States and foreign countries, in consideration of the payment of a ten per cent royalty to Mr. Sunnen. Two of the contracts could be cancelled by either party on six months' written notice; and two could be cancelled on one year's written notice. Immediately after executing such contracts Mr. Sunnen assigned all of his right, title, and interest in and to said contracts to his wife, and duly notified the company of his action. When these events took place Mr. Sunnen owned a majority of the stock of Sunnen Products Company, his wife owned a substantial minority stock interest, the vice-president of the company owned a substantial minority stock interest, and two other officials of the company owned one share each. These five individuals were directors of the company, and no action binding upon the company could have been taken except by vote of three of such directors (R. 32). The manufacture and sale of these grinding machines constituted more than half of the business of the company (R. 32). In connection with this business the company employed between 90 and 220 persons, and incurred substantial debts (R. 32). No notices to cancel the royalty agreements were given or received by either party, and the

agreements remained in effect during the years here involved (R. 31).

Is such an assignor taxable upon royalties paid to the assignee?

A. The decision of the Tax Court in the Estate of J. G. Dodson v. Commissioner, 1 T. C. 416, is not controlling.

In support of his contention that Mr. Sunnen is liable for income taxes on these royalties, the petitioner cites *Estate of Dodson v. Commissioner*, supra. As shown on pages 14 and 15 of his brief, the Tax Court decided against the Dodson Estate because of Dodson's alleged power, as majority stockholder, to cause the corporation to cancel the royalty contract previously executed by him and it. This power, the Tax Court said, was equivalent to "unilateral action" by Dodson. Consequently, the Tax Court determined that even after Dodson assigned a one-half interest in the royalty contract to his wife, he remained the owner of the entire royalty contract for all substantial and practical purposes.

We contend that the Dodson case is distinguishable because it involved no independent directors and stockholders; and that it is clearly wrong.

We also contend that the Tax Court's decision in Mr. Sunnen's case is clearly wrong.

In its decision in the case at bar the Tax Court overlooked entirely the control and powers which Mrs. Sunnen acquired as assignee of the royalty contracts, to-wit: (1) Her power to sell or give away the royalty contracts immediately after she had received the assignments thereof, (2) her power to cancel the contracts upon notice, (3) her power, with the consent of the company, to alter or amend the royalty contracts, (4) her power to sue the

company for breaches of said contracts, etc. Moreover, the Tax Court overlooked entirely the control and powers which Mrs. Sunnen possessed as a substantial minority stockholder of Sunnen Products Company. The Tax Court did not weigh these powers of Mrs. Sunnen with the alleged power of Mr. Sunnen. The Tax Court saw only his power as majority stockholder, and concluded that he and the corporation could cancel the royalty contracts. Such power, in the Tax Court's opinion, was equivalent to unilateral action on Mr. Sunnen's part.

We deny that Mr. Sunnen had power to force Sunnen Products Company to cancel the royalty contracts. His voting rights as majority stockholder do not permit him to thus ride roughshod over the rights possessed by his wife, as assignee of the royalty contracts, and as a substantial minority stockholder of the corporation.

In regard to Mrs. Sunnen's rights as assignee of the royalty contracts, we respectfully call attention to the following language used in 6 *Corpus Juris Secundum:*

> "The assignment of a contract operates not merely as an assignment of the moneys thereafter to be earned, but of the whole contract, with its obligations and burdens. * * * (Sec. 84, p. 1142).
>
> "Unless a contrary intention is manifest or inferable, an assignment ordinarily carries with it all rights, remedies, and benefits which are incidental to the things assigned; * * *." (Sec. 85, p. 1142).
>
> **"The assignor, after an unqualified assignment and notice to the debtor, usually loses all control over the chose and can do nothing to defeat the rights of the assignee"** (Sec. 96, p. 1152).
>
> "Although the original parties may make a binding compromise or settlement before the debtor has been notified of the assignment, after notice has been given of an unqualified and absolute assignment, they cannot do so, nor can the assignor release or extinguish the debt assigned" (Sec. 97, p. 1153).

"As the assignment passes all the assignor's title or interest to the assignee * * *, **and divests the assignor of all right of control over the subject matter of the assignment** * * *, it is usually held that by the mere fact of the assignment the assignor impliedly guarantees or agrees that he will not thereafter interfere with the thing assigned, and, if he does interfere to the damage of the assignee, he renders himself liable to the assignee for any damage resulting from such interference. **Any act of dominion by the assignor over the thing assigned, depriving the assignee of title or right to possession, is a conversion** for which the assignor may be held liable in tort; and, if the assignor proceeds to collect the sum due on an assigned chose the moneys so coming into his hands are regarded as trust funds belonging to the assignee, who may recover the same either in an action for money had and received or in tort for conversion" (Sec. 101, p. 1158). (Emphasis supplied.)

Likewise, in 4 *American Jurisprudence*, p. 312, it is said:

"Sec. 105. Protection of assignee against acts of the assignor * * *. **In courts of law as well as in those of equity, after notice to the debtor of an assignment, the interest of a bona fide assignee of a chose in action will be protected against any unauthorized act on the part of the assignor tending to interfere with the rights of the assignee.** This protection extends to the nullifying of collusive agreements of the assignor and debtor to defeat the rights of the assignee." (Emphasis supplied.)

See also *P. N. Gray & Company, Inc., v. C. A. Valliotis*, 276 Fed. 565, 569, affirmed 293 Fed. 1018, holding that by an assignment of a contract the assignor contracts that he will do no act to deprive the assignee of his rights under the assigned contract.

Missouri law, which governs Mrs. Sunnen's rights under these assignments, applies these general principles. *Houser*

v. Richardson, 90 Mo. App. 134; *Leahy v. Dugdale*, 41 Mo. 517; *Lord v. Schamloeffel*, 50 Mo. App. 360; *Buffington v. South Missouri Land Company*, 25 Mo. App. 492.

These authorities clearly show, we think, that Mrs. Sunnen could obtain relief from a court of equity to protect her against any collusive or arbitrary action taken by Mr. Sunnen, through Sunnen Products Company, to defeat her rights.

Nor could Mr. Sunnen, by exercising his rights as majority stockholder, arbitrarily cause the corporation to cancel the royalty agreements, thereby forcing it to lose over half of its profitable business, and thus seriously depreciating the value of Mrs. Sunnen's stock. This is shown by the following authorities:

13 *Fletcher, "Cyclopedia of the Law of Private Corporations"*:

> (Page 137) "If the corporate officers or majority stockholders threaten or commit acts which constitute a breach of trust, or are fraudulent or unfair or otherwise wrongful, even if the acts are not beyond the powers of the corporation nor positively forbidden by statute or public policy, minority stockholders may sue to prevent or redress such injuries, * * *."
>
> (Page 141) "Equity will never countenance any scheme to defraud, no matter how novel and ingenuous. Actual dishonesty of those in control is not necessary."
>
> (Page 144) "A majority of the stockholders, no matter how large, have no right to divert assets of the company to the detriment of minority stockholders, and if they do so relief may be granted to minority stockholders."
>
> (Page 147) "If the owners of a majority of the stock of a corporation take advantage of their posi-

tion and of their influence over the directors or other officers, to obtain an inequitable contract with or conveyance or lease from the corporation, they perpetrate a fraud upon the minority, and the contract, lease, or conveyance will be set aside in equity at the suit of dissenting stockholders."

(Page 154) "A stockholder may sue to enforce a contract which has been fraudulently rescinded or fraudulently broken by anticipation."

(Page 156) "Management of the corporation by those in control, for their own interest or profit, to the exclusion of minority stockholders, is ground for relief."

18 *Corpus Juris Secundum*, p. 1194:

"The ownership of a majority of the stock gives the holder no greater right to the property of the corporation than if he owned a small percentage of the shares."

13 *American Jurisprudence*, p. 477:

"Majority stockholders will not be permitted to discontinue the business of a corporation for the purpose of turning it over to another—and excluding minority stockholders from participating therein."

Pepper v. Litton, 308 U. S. 295, 306, 307, 311:

"A director is a fiduciary. *Twin-Lick Oil Co. v. Marbury*, 91 U. S. 587, 588, 23 L. ed. 329, 330. So is a dominant or controlling stockholder or group of stockholders. *Southern P. Co. v. Bogert*, 250 U. S. 483, 492, 63 L. ed. 1099, 1107, 39 S. Ct. 533. Their powers are powers in trust. See *Jackson v. Ludeling*, 21 Wall 616, 624, 22 L. ed. 492, 495. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent

fairness from the viewpoint of the corporation and those interested therein. *Geddes v. Anaconda Copper Min. Co.*, 254 U. S. 590, 599, 65 L. ed. 425, 432, 41 S. Ct. 209. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. * * *

"* * * He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. * * * He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation."

We contend, therefore, as was said in *Flarsheim v. U. S.*, 156 Fed. (2d) 105, 108, that Mrs. Sunnen's contract rights were "an equitable charge upon the business itself which a court of equity would enforce." We contend, further, that Mrs. Sunnen could not be deprived of her rights, through cancellation of the contracts, unless and until three directors of the company in good faith determined that further performance of the royalty contracts was not profitable to Sunnen Products Company. Joseph Sunnen, alone, could not make such determination. Joseph Sunnen, alone, could not cause the company's operations to be profitable or unprofitable. Consequently, we submit that

Joseph Sunnen's alleged power to cancel the contracts was anything but equivalent to unilateral action on his part.

This is even more apparent when it is remembered that the pinhole grinder royalty contract (R. 37) and the crankshaft grinder royalty contract (R. 43) could not have been cancelled even by the corporation during any one of the years here involved. Both agreements required, for cancellation, that an advance notice of one year be given to the other party. No such notices were given (R. p. 31, par. 22). Consequently, as each year passed, without notice having been given, these agreements were not subject to cancellation by either party in the succeeding year. See *Lewis v. White*, 56 Fed. (2d) 390; *Faber v. U. S.*, 1 Fed. Supp. 859; *Langley v. Commissioner*, 61 Fed. (2d) 796; *Ashforth v. Commissioner*, 26 BTA 1188; and G. C. M. 11640, XII-1 C. B. 144, all holding that if the grantor of a revocable trust does not give the prescribed advance notice of his intent to revoke it, the trust is irrevocable during the years under consideration. It is true, of course, that we are not now considering a revocable trust. Nevertheless, the same principles regarding notice are obviously applicable. And, as pointed out in *Funk, W. J. v. Commissoner*, 3 T. C. M. 100 (CCH Dec. No. 13,727M, 1947 P-H T. C. Memo. Dec. Par. 44,030), the liability of the taxpayer "must be based upon circumstances existing in the taxable year in question."

In addition to these considerations we contend that the Tax Court's decision in Mr. Sunnen's case, and in *Estate of Dodson v. Commissioner*, supra, violates principles announced by this court in *Commissioner of Internal Revenue v. Wilcox*, 327 U. S. 404. Therein this court said that even full dominion and control of money or property is not decisive in all cases; that the very essence of taxable income is the accrual of some gain, profit, or benefit to the taxpayer;

and that without some bona fide legal or equitable claim to the funds involved, the taxpayer cannot be said to have received any taxable gain or profit. Therefore, even if we admit for the sake of argument that Mr. Sunnen could have used his power as majority stockholder to force the company to cancel the royalty contracts, it seems to us that this fact is not sufficient. Mr. Sunnen could have received no gain, profit, or benefit from such cancellation. Such cancellation would only deprive Sunnen Products Company of more than half of its business, throw many of its employees out of work, cause trouble with the company's creditors, and seriously depreciate the value of Mr. Sunnen's stock (See R. p. 32). Moreover, the exercise of such power could give Mr. Sunnen no legal or equitable claim to any royalties paid, or payable, to Mrs. Sunnen. Nor could the exercise of such power give Mr. Sunnen anything falling within the following definition of income adopted in *Eisner v. Macomber*, 252 U. S. 189, 207, "* * * something of exchangeable value * * * received or drawn by the recipient (the taxpayer) for his own separate use, benefit, and disposal." Of course, the exercise of such power might conceivably afford some vindictive satisfaction to Mr. Sunnen if his wife should divorce him. Nevertheless, as said in *Helvering v. Stuart*, 317 U. S. 154, 168:

> "Economic gain realized or realizable by the taxpayer is necessary to produce a taxable income under our statutory scheme. * * *. The 'non-material satisfaction' (gift-contributions) of a donor are not taxable as income."

We respectfully submit, also, that the Tax Court's decision in the case at bar directly conflicts with *Blair v. Commissioner*, 300 U. S. 5. In connection with the Blair case it is interesting to note that Mr. Blair, who assigned a part of his equitable interest in the corpus of a trust

created by his father's will, was also a co-trustee with his son of that trust (*Commissioner v. Blair*, 60 Fed. [2d] 340, 341; *Blair v. Commissioner*, 31 B. T. A. 1192), and that the co-trustees of such trust had broad power to control and manage the trust property (*Blair v. Commissioner*, 18 B. T. A. 69).

B. **Assignment of income or income producing property.**

On page 16 et seq. of his brief the petitioner argues that Mr. Sunnen is taxable upon the royalties paid to his wife because he did not part with the patents, and that the patents were in reality the ultimate source of the royalties.[1]

The petitioner cites no authority in support of his argument.

This argument was rejected by the Board of Tax Appeals in Mr. Sunnen's prior case (R. 59-60). The Board cited many authorities[2] including the closely analogous case of *Edward G. Swartz, Inc., v. Commissioner*, 5 Cir., 69 Fed. 2d 633, 635. In that case Mr. Swartz, who owned timber land, entered into a timber cutting contract with Bernard Cypress Company, providing for the payment to him of part of the profits derived from the cutting and sale of the timber. Subsequently, Mr. Swartz assigned all of his right, title, and interest in and to this contract to Edward G. Swartz, Inc., in exchange for all of its stock

1 This argument overlooks the fact that while the crank-shaft grinder royalty contract was assigned on June 20, 1939, and royalties were paid from that date, the two crank shaft grinder patents were not issued until May 6, 1941 and January 26, 1943, respectively (R. 29). Patents are not in existence until issued, and could not in any event produce income before they are issued. The taxable years here involved are 1937-41, both inclusive.

2 *Nelson v. Ferguson*, 3 Cir., 56 Fed. 2d 121, 124, cert. den. 286 U. S. 565 (wherein the assignee of the royalty contract had no interest whatever in the patent); *Leydig v. Commissioner*, 15 B. T. A. 124, affd. 10 Cir., 43 Fed. 2d 494; *Field v. Commissioner*, 2 Cir., 42 Fed. 2d 820, 822; *Copland v. Commissioner*, 7 Cir., 41 Fed. 2d 501, 504; *Smith et al., Extrs., v. Commissioner*, 25 B. T. A. 291; *Lowery v. Helvering*, 2 Cir., 70 Fed. 2d 713, 714.

except two qualifying shares. Swartz, however, individually retained ownership of the lands. In answer to the contention of the corporation that all income paid to it by the Cypress Company was taxable to Mr. Swartz individually, the Court on page 635 said:

> "Here the creator (Swartz) has assigned to the creature (Edward G. Swartz, Inc.) the thing itself from which the income flows. Before the assignment Swartz was the owner of the income because he owned the contract which yielded it. After the assignment the company owned the income, for after it the contract was not Swartz's but its own. The petitioner's claim that it was not the owner of the income because Swartz had not assigned to it the timber but only the contract, is without merit. The actual, the present interest in the timber, the right to have it cut and marketed, and the right to the proceeds from that cutting and marketing, Swartz, by assigning the right and title to the contract, assigned to petitioner. Unless and until there was a breach sufficient to authorize cancellation of the contract, the right Swartz had in the timber was the right to insist that it be cut as the contract provided, and that he receive for it the price the contract fixed. These rights he fully assigned to petitioner. The ownership of these rights involved, it drew to itself all that proceeded from the contract. The owner of these rights was the owner of the income they produced. Nothing in the *Earl Case* (281 U. S. 111, 74 L. Ed. 731), or in those which have followed it, makes these payments taxable to Swartz. To tax Swartz and not petitioner would, we think, be to impose a tax on one on account of the income of another." (Citing *Poe v. Seaborn*, 282 U. S. 101, 51 S. Ct. 58, 75 L. Ed. 239; *Hoeper v. Tax Commission*, 284 U. S. 206, 52 S. Ct. 120, 76 L. Ed. 248, and other cases.)

Even the Tax Court, in the case at bar, did not repudiate the principle that a contract right to a certain percentage of the royalties on an invention is itself income-producing

property and the holder of such right is taxable on the royalties paid thereunder. This is clearly shown by *Strauss v. Commissioner*, 8 T. C. No. 121, CCH Decision No. 15,787, decided May 15, 1947. In that case the Tax Court held that a husband, who helped finance the development and patenting by others of a process for making colored film known as Kodachrome, who for such financial assistance acquired a right to receive a certain percentage of royalties on and an interest in the process, and who later, as a gift, assigned to his wife (who had no interest whatever in the patents) all of his "right, title, and interest in Kodachrome," was not taxable on royalties subsequently paid to his wife. *Sunnen v. Commissioner*, 6 T. C. 431, was distinguished solely because of the alleged control possessed by Mr. Sunnen over Sunnen Products Company.

The petitioner's argument that the patent and patent applications produced the royalties paid to Mrs. Sunnen was also flatly rejected by the Circuit Court of Appeals in the case at bar (R. 95, 96).[3]

Moreover, the petitioner's argument conflicts with the fundamental principles enunciated in the following cases, which have never been repudiated by this Court: *Lilienfeld v. Commissioner*, 35 B. T. A. 391, 395 (acquiesced in by Commissioner, 1937—1 C. B. 15), (involving royalty contracts assigned to wife who had no interest in patent); *Timken, Est. of H. H. v. Commissioner*, 47 B. T. A. 494, affd. 6 Cir., 141 Fed. 2d 625 (note with past due interest assigned); *Ray, Rose L. v. Commissioner*, 1941 P-H, B. T. A. Memo. Decision Par. 41,325, CCH Decision No.

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3 The Circuit Court of Appeals cited *Commissioner v. Field*, supra; *Lowery v. Helvering*, supra; *Hall v. Burnett*, App. D. C., 54 Fed. 2d 443, 446, cert. den. 285 U. S. 552; *Nelson v. Ferguson*, supra; *Helvering v. Seatree*, App. D. C., 72 Fed. 2d 67, 68; *Shanley v. Bowers*, 2 Cir., 81 Fed. 2d 13, 15; *Commissioner v. O'Donnell*, 9 Cir., 90 Fed. 2d 907, 910, revd. on other grounds, 303 U. S. 370; *Commissioner v. Ross*, 6 Cir., 83 Fed. 2d 18, 19, 20; *Lum v. Commissioner*, 3 Cir., 147 Fed. 2d 356, 357; and *Blair v. Commissioner*, 300 U. S. 5, 13.

11874A, B. T. A. Dkt. No. 101315, decided June 26, 1941 (oil and gas leases assigned); *Commissioner v. Montgomery*, 5 Cir., 144 Fed. 2d 313, 316 (construction contract assigned to family corporation by majority stockholder); *Fox v. Commissioner*, 37 B. T. A. 271, 278 (royalty contract assigned to corporation by sole stockholder); *Montgomery v. Thomas*, 5 Cir., 146 Fed. 2d 76, 80 (stock in family corporation purchased for children by majority stockholder); *Ross, Est. of W. L. v. Commissioner*, T. C. Memo. Opinion, 2 T. C. M. 573, 575, CCH Decision No. 13,416M (contract assigned); *Allen v. First National Bank and Trust Company*, 5 Cir., 157 Fed. 2d 592 (life interest in trust corpus assigned), cert. den. on March 3, 1947, 91 L. Ed. 691; *Porter Royalty Pool, Inc., v. Commissioner*, 7 T. C. 685, 696-697, CCH Decision No. 15,362 (interest in oil leases assigned to corporation by landowner); *Funk, W. J. v. Commissioner*, T. C. Memo. Opinion, 3 T. C. M. 100, CCH Decision No. 13,727M, 1947, P-H, T. C. Memo. Decision Par. 44,030, and *Funk, E. M. v. Commissioner*, 7 T. C. 890, CCH Decision No. 15,397 (both involving stock in family corporation assigned by President and majority stockholder); and *Wheelock v. Commissioner*, 7 T. C. 98, CCH Decision No. 15,216 (stock in family corporation assigned by President and majority stockholder). Compare also *Friedman v. Commissioner*, 45 B. T. A. 976, 983, affd. 4 Cir., 130 Fed. 2d 305 (involving assigned attorney-client contract).

In addition, we desire to point out that to adopt the petitioner's argument—to hold that the patents were the income-producing property—would lead to such absurd tax results as taxing a person who might buy the patents from Mr. Sunnen on royalties paid after such purchase to Mrs. Sunnen; and taxing Mr. Sunnen, if he retained the patents, on royalties paid to one who might buy the royalty contracts from Mrs. Sunnen. The property rights involved in the patents and contracts were separate and distinct.

Clearly these royalties were produced by the royalty contracts. Without them Mr. Sunnen's patents and patent applications would not have been exploited. No labor or capital would have been used to make and sell these grinding machines, and no royalties would have been paid to anyone. Unexploited patents never produce income. The actual and present interest in the patents, the right to have the patented devices manufactured and sold, and the right to a part of the proceeds of that manufacture and sale, Mr. Sunnen, by assigning all of his interest in the royalty contracts, assigned to Mrs. Sunnen. These views, which are in accord with principles long since firmly established by this Court, were adopted by the Circuit Court of Appeals in the case at bar. In its opinion the Circuit Court of Appeals said:

> "Unlike the transactions involved in *Helvering v. Horst*, supra; *Harrison v. Schaffner*, supra, and other cases cited supra, here the assignments of the royalty contracts were conveyances *in praesenti* of vested income-producing property rights. They were not mere gifts of money payable in the future from the earnings of the donor or from income-producing property owned by him. A royalty contract resembles a lease of real property, and the royalties payable thereunder are analogous to rent. Had the royalty contracts not been assigned in the present case the royalties when paid to Sunnen would have been income taxable to him, the same as rents are taxable to the landlord. *Burnet v. Harmel*, 287 U. S. 103, 108. After the assignments the royalties were 'no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away.' *Helvering v. Horst*, supra, 311 U. S., at page 119" (R. 96).

Nevertheless, in footnote 4 on page 21 of his brief, the petitioner seeks to avoid the clear language used by this Court in the *Horst* case, supra. He argues that for a land-

owner to be relieved from income taxes on rent paid under a lease assigned by him, the landowner must also assign his entire interest—the land as well as the lease. This argument is directly contrary to *Lum v. Commissoner*, supra; *Edward G. Swartz, Inc., v. Commissioner*, supra, and *Porter Royalty Pool, Inc., v. Commissioner*, supra. Compare also *J. S. Abercrombie Co. v. Commissioner*, 7 T. C. 120, affd. by the Circuit Court of Appeals of the Fifth Circuit on June 25, 1947, 162 Fed. 2d 338, 1947 CCH Standard Federal Tax Reporter, Vol. 4, Par. 9301, holding that assignees were taxable upon income accruing to their interests under assigned oil and gas leases, despite reservations of capital investment in minerals by the assignors.

C. **The Clifford doctrine is not applicable.**

While conceding the truth of the general proposition that the owner of property is no longer taxable upon the income therefrom after he has disposed of the property itself,[4] the petitioner argues that he may still be accountable for tax upon such income where he has retained incidents of ownership in the underlying property, particularly where the income is merely reallocated within the family group. In support of his argument the petitioner cites *Helvering v. Clifford*, 309 U. S. 331, which involved a short-term family trust, non-assignability of interest by the beneficiary, reverter to the grantor, and broad powers of control and management without liability vested in the grantor-trustee of such trust. The petitioner makes this contention despite the fact that no trust is involved in the case at bar and the Circuit Court of Appeals of the Fifth Circuit in *Commissioner v. Montgomery*, 144 Fed. 2d 313, 316, said: "*A lawfully organized and operated busi-*

[4] This concession must be made in view of *Pearce v. Commissioner*, 315 U. S. 543, 554, in which this court limited the application of *Helvering v. Horst*, 311 U. S. 112; *Helvering v. Eubank*, 311 U. S. 122, and *Harrison v. Schaffner*, 312 U. S. 579.

ness corporation is not the equivalent of a trust." Furthermore, the petitioner alleges that the *Clifford* Doctrine is applicable even though Judge Magruder in *U. S. v. Morss*, 1 Cir., 159 Fed. 2d 142, 143, 146, pointed out that such doctrine applies only where the retained property rights coincide substantially "with the normal concept of full ownership," and where the rights given away are "insignificant."

We contend that the *Clifford* Doctrine cannot be enlarged and extended to cover this case. This is apparent when we weigh both the property rights given to Mrs. Sunnen, and the property rights, if any, retained by Mr. Sunnen.

When the assignments were delivered to Mrs. Sunnen, and Sunnen Products Company received notice thereof, she acquired the following rights: the right to sell, assign, give away, pledge, or otherwise dispose of the royalty contracts—**rights which Mrs. Clifford did not possess** (309 U. S., at page 333)—; the right to cancel the royalty contracts in accordance with their terms; the right, with the consent of Sunnen Products Company, to alter or amend the royalty contracts so as to provide for greater or lesser royalties, payment of minimum royalties, etc.; the right to sue to enforce performance in good faith by Sunnen Products Company of such contracts; and the right to sue for damages for the breach thereof. These rights were substantially the same as the rights of the assignees in *Blair v. Commissioner*, 300 U. S. 5, 13, 14. In addition, Mrs. Sunnen, as bona fide assignee, had the right to claim the protection of the Courts of law and equity against any unauthorized, collusive, or arbitrary action by Mr. Sunnen, as assignor or as majority stockholder of Sunnen Products Company, tending to interfere with, or defeat her rights. 4 *Am. Jur.*, "*Assignments*," Sec. 105, p. 312; 6 *C. J. S.*, s. 96, p. 1152, s. 101, p. 1158. Even the Commissioner's own

Regulation[5] provides that where a transferee of property has such power over the property transferred, the *Clifford* Doctrine imposes ownership, and tax liability, on such transferee. See also *Richardson v. Commissioner*, 2 Cir., 121 Fed. 2d 1, 3, cert. den. 314 U. S. 684; *Jergens v. Commissioner*, 5 Cir., 136 Fed. 2d 497, 498; *Emery v. Commissioner*, 1 Cir., 156 Fed. 2d 728, 730; and *Conant v. Commissioner*, 7 T. C. 453, 461, all holding that transferees having analogous, or even lesser powers, to deal with corpus of the property transferred are to be deemed the substantial owners of such property.[6] It is clear, therefore, that the rights and powers given to Mrs. Sunnen, as assignee, are anything but "insignificant."

And in addition to these rights possessed by Mrs. Sunnen, as assignee, she possessed all rights incident to her ownership of 200 shares of stock of Sunnen Products Company (R. 26). Such rights gave her the power to prevent Mr. Sunnen, as majority stockholder of the company, from taking any steps to force the company to cancel the royalty contracts, and thus lose over one-half of its profitable business.[7]

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5 Regulation 111, Sec. 29.22 (a)-22, 47† CCH Par. 86B:—"Where a person other than the grantor of property transferred in trust has a power exercisable solely by himself to vest the corpus or income therefrom in himself, the income therefrom shall be included in computing the net income of such person."

6 Compare also *Mallinckrodt v. Nunan*, 8 Cir., 146 Fed. 2d 1; *Busch v. Commissioner*, 8 Cir., 148 Fed. 2d 798.

7 (See authorities cited under Subdivision A above.) That income tax liability cannot be predicated upon the power of a majority stockholder was also recognized in the following cases: *Fox v. Commissioner*, supra, where the taxpayer was sole stockholder of the corporation; *Commissioner v. Montgomery*, supra, where the taxpayer was a director, president, and owner of two out of three shares of the voting stock; *Commissioner v. Greenspun*, 5 Cir., 156 Fed. 2d 917, where the taxpayer was sole stockholder and president of the company; *Funk, W. J., v. Commissioner*, supra, where the taxpayer was a director and owned all voting stock; *Wheelock v. Commissioner*, supra, where taxpayer was president and held proxies to vote all stock; *Edward G. Swartz, Inc., v. Commissioner*, supra, where taxpayer owned all except qualifying shares; *Bear Gulch Water Co. v. Commissioner*, 9 Cir., 116 Fed. 2d 975, holding private corporation taxable on its income although all of its stock was held by a tax-exempt State University; and *Moline Properties, Inc., v. Commissioner*, 319 U. S. 436, holding corporation taxable on gains from sales made by it although one man owned all of its stock.

Let us turn now to the powers which petitioner claims that Mr. Sunnen reserved. These are described on pages 17 et seq. of his brief. These powers were all called to the attention of the Circuit Court of Appeals, were evaluated by it, and were held to be too nebulous to justify imposition of income tax liability on Mr. Sunnen.

In addition to the reasons given by the Circuit Court of Appeals for its views, we wish to call attention to the following facts: The royalties paid were 10% of the gross sales. Mrs. Sunnen received, during the five years here involved, over $261,000.00 (R. 30). Gross sales of said machines amounted to over $2,610,000.00. These sales constituted over half of the business of Sunnen Products Company (R. 32). Mr. Sunnen owned 1,780 shares, Mrs. Sunnen owned 200 shares, and others connected with the company owned the balance of 20 shares of the company's stock (R. 26). Consequently, if Mr. Sunnen had attempted to use his voting powers to elect directors committed to a program of cancelling the royalty contracts, he would have harmed himself more than anyone else—would have seriously depreciated the value of his own stock.[8] Therefore, it is not realistic to assume that he would have taken such action. It is not realistic to assume that he would have been willing to thus depreciate the value of the minority stock interests. It is not realistic to assume that he would have thus jeopardized the company's power to pay its debts.[9] It is not realistic to assume that he would have thus destroyed the carefully trained organization which the company had built up.[10] It is not realistic to assume that

8 Similar self-interest prevented application of the *Clifford* doctrine in *Wachovia Bank & Trust Company, Trustee, et al. v. Commissioner*, 3 TCM 595, 601, CCH Decision No. 14,001M, 1944 P-H, TC Memo Decision Par. 44,217; and in *Wheelock v. Commissioner*, 7 T. C. 98, 107. Moreover, for the same reasons, self-interest on the part of Mr. Sunnen would have prevented him from granting licenses to competitors of Sunnen Products Company.

9 See (R. 32) for amount of debts owed by Sunnen Products Company.

10 See (R. 32) for number of employees of Sunnen Products Company.

he would have been willing to thus defraud his wife of the rights which he had given her as assignee, or to assume that she would have agreed to a course of action depriving her of over $261,000.00.

It is no answer to say, as does petitioner, on page 18 of his brief, that cancellation of the royalty contracts would not necessarily have been a fraud on the company, because Mr. Sunnen and the company could then have entered into contracts more favorable to it. Any such substituted contracts, if more favorable to the company, would have clearly defrauded Mrs. Sunnen of her rights as assignee of the original contracts. And we must base this case on what was done, not what might have been done. Nor is the petitioner's case helped by saying that Mrs. Sunnen had no standing to complain of cancellation by the company, since the contracts gave it the right to cancel upon notice. Surely petitioner does not seriously believe that these contract provisions would have prevented Mrs. Sunnen, as assignee and minority stockholder, from objecting to Mr. Sunnen arbitrarily and unfairly doing indirectly through the corporation what he could not do directly, in derogation of the interests of the corporation, its minority stockholders, and its creditors.

Moreover, the petitioner's argument, regarding Mr. Sunnen granting licenses to competitors of Sunnen Products Company, takes the case out of the realm of established fact, and pitches it into the realm of pure speculation. If speculation is in order, we are justified in making the following guesses: Mr. Sunnen would not license any competitor so long as he owned 89% of the stock of Sunnen Products Company. No competitor would pay for a license so long as Mr. Sunnen remained president of Sunnen Products Company. If competition had occurred, it might even have stimulated the employees of

Sunnen Products Company to greater efforts. And in any event, any such scheme of a majority stockholder to thus divert corporate profits into his own pocket would clearly be a fraud on the rights of the minority stockholders of Sunnen Products Company. We say, therefore, that the results claimed by the petitioner do not necessarily follow. We say, too, that this case must be decided upon actual facts affecting the particular property involved and not upon guesses as to what Mr. Sunnen might or might not have done with other property belonging to him.

In effect, the petitioner bases his case on Mr. Sunnen's alleged power to wrongfully misappropriate his wife's money—to do so in violation of all standards of decency and common honesty. Petitioner's argument is substantially the same as that advanced by him in *Commissioner v. Wilcox* (327 U. S. 404, 407), but this Court rejected such argument on the ground that Wilcox had no rightful claim to the funds involved. As the Circuit Court of Appeals said in its decision in the case at bar (R. 97), "Neither the Tax Court nor this Court should base a decision upon conjecture or possible fraud." As the Tax Court said in *Wheelock v. Commissioner*, supra (7 T. C. 98, 107) taxation should be upon a base more stable than power of a taxpayer to sabotage his company, or to make or break the business.[11]

Moreover, we wish to point out that acceptance of Commissioner's views will have far reaching and dangerous consequences. The petitioner says that Mr. Sunnen's power (as majority stockholder, as President, and as owner of property leased to the corporation) to affect the amount of income paid to his wife, is a sufficient basis for requiring him to pay a tax upon that income. But such a holding

11 In *Wheelock v. Commissioner*, supra, the taxpayer was president of an incorporated advertising business, and had power to vote all stock of the company.

would logically require that he be taxed upon all income of the Sunnen Products Company, for he had just as much power over its entire income as he did over the 10% royalties paid by it to Mrs. Sunnen. And to hold him taxable on all of the corporation's income would clearly violate *Moline Properties, Inc., v. Commissioner*, supra, wherein even a sole stockholder was held not taxable upon the income of the corporation. Furthermore, to hold that Mr. Sunnen's alleged power to end his wife's right to receive royalties imposes tax liability upon him, logically requires that every majority stockholder be held taxable for dividends upon callable stock issued by a corporation to parties in no way connected with such majority stockholder, and be held taxable for rent paid by the corporation under cancellable leases held by strangers.

It seems to us, therefore, that petitioner's arguments obviously prove too much. They overlook the substantial adverse interests possessed by Mrs. Sunnen and others similarly situated.[12] They ignore the principle that powers which are not presently exercisable, and may never be capable of being exercised, do not exist[13]—that powers conditioned on acts which one may not be able to perform, are not the equivalent of "unfettered command."[14] They overlooked the fact that powers of control and manage-

12 An adverse interest is no less adverse because held by one's wife. Her identity cannot be merged with that of her husband. The history of divorce courts, and the modern tendency toward recognition of separate legal rights in wives, opposes such an approach. *Wheelock v. Commissioner*, supra. See also *Commissioner v. Branch*, 1 Cir., 114 Fed. 2d 985, 987, pointing out that the Clifford Doctrine does not obliterate the separate legal personality of a wife; and *Backus, Est. of Standish, v. Commissioner*, 6 TC 1036, 1046, CCH Decision No. 15,142, holding that a husband is not the alter ego of his wife. The presence of adverse interests prevented application of the Clifford Doctrine in *Commissioner v. Betts*, 7 Cir., 123 Fed. 2d 534, 537-540; and *Commissioner v. Katz*, 7 Cir., 139 Fed. 2d 107, 110. Compare also *Reinecke v. Northern Trust Co.*, 278 U. S. 339, 346, holding that power to revoke a trust, with consent of a person having an adverse interest, does not prevent the immediate shifting of economic benefits.

13 *Corning v Commissioner*, 6 Cir., 104 Fed. 2d 329, 332, citing 1 Sugden on Powers, 3d Am. Ed. 371, 372.

14 *Shanley v. Bowers*, 2 Cir., 81 Fed. 2d 13, 15.

ment, no matter how unlimited and absolute they may be, are not a sufficient basis for imposition of tax liability, unless the possessor could derive economic gain from the exercise thereof. This proposition was clearly stated in *Commissioner v. Wilcox*, supra.[15]

In addition, it is not reasonable, just, or expedient to the government, to impose income taxes upon Mr. Sunnen in respect of income which he can never use to pay such taxes. Such taxation violates the principle that graduated income taxes should be levied according to ability to pay. Such taxation violates *Hooper v. Tax Commission*, 284 U. S. 206, 215, holding it unconstitutional to tax one person upon the income of another. And, such taxation seriously jeopardizes the Government's ability to collect its taxes (especially when tax rates reach 91%)—a matter which is just as important as the proper assessment of taxes. No doubt these considerations cause Congress to refuse to tax husband and wife as one, though urged to do so.[16] No doubt these considerations caused Congress to refuse to make the family the taxable unit, and caused it to permit a taxpayer to minimize his taxes by making gifts of income-producing property to others, including members of his family.[17]

For these reasons, we submit that the rights and powers acquired by Mrs. Sunnen were of far greater magnitude

15 See also *Jones v. Norris*, 10 Cir., 122 Fed. 2d 6, 11; *Commissioner v. Betts*, 7 Cir., 123 Fed. 2d 534, 537; *Cushman v. Commissioner*, 2 Cir., 153 Fed. 2d 510, 513, 514. Compare the following cases where the Clifford Doctrine was not applied despite broad powers of control and management possessed by settlor: *Commissioner v. Branch*, 1 Cir., 114 Fed. 2d 985, 987; and *Suhr v. Commissioner*, 6 Cir., 126 Fed. 2d 283, 287.

16 See Revenue Bill of 1941, H. R. 5417, as introduced, 77th Cong., First Session, Sec. 111; H. Rep. No. 1040, 77th Cong., First Session, p. 10, Cong. Rec., Vol. 87, Part 6, pp. 6727-6732; "Mandatory Joint Returns," Joint Committee on Internal Revenue Taxation, U. S. Government Printing Office, 1941.

17 *U. S. v. Morss*, 159 Fed. 2d 142, 143.

than those possessed by her husband, that he cannot fairly be treated as the full owner of property which his wife could freely sell or otherwise dispose of, and that *Helvering v. Clifford*, supra, is not controlling. Every possible argument for using that case to justify taxing Mr. Sunnen upon these royalties, can be repeated with greater force and effect to justify taxing such income to Mrs. Sunnen.

D. **Earned Income.**

As pointed out above, the petitioner contends that Mr. Sunnen's patents were the ultimate source of the royalty income. However, he apparently also contends that these royalties were income earned by Mr. Sunnen, for on page 19 of his brief he cites *Lucas v. Earl*, 281 U. S. 111; *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293. These contentions are inconsistent.

Moreover, any claim that these royalties constitute earned income of Mr. Sunnen is obviously absurd. The royalties were part of the income earned by Sunnen Products Company, which supplies the labor and capital necessary to manufacture and sell the grinding machines—a fact always recognized by the petitioner when requiring Sunnen Products Company to pay a tax upon its income. Customers of Sunnen Products Company bought and paid for grinding machines, not service rendered by Mr. Sunnen.

These facts were recognized by the Board of Tax Appeals in Mr. Sunnen's prior case (R. 59, 60), and *Lucas v. Earl*, supra, was distinguished (R. 58).

Lucas v. Earl, supra, was also urged upon the Circuit Court of Appeals in the case at bar, but that court ignored it (R. 95).

Commissioner v. Tower, supra, is also distinguishable. Therein the evidence amply supported the Tax Court's holding that the income was in fact earned by the husband (*Commissioner v. Tower*, 327 U. S. 280, 284, 292).[18] Moreover, the Tower case is distinguishable on the ground that Mr. Tower never executed a completed gift of property to his wife (*Commissioner v. Tower*, 327 U. S. 280, 283), whereas in the case at bar the validity of Mr. Sunnen's gift is not attacked.

Nor is *Lusthaus v. Commissioner*, supra, controlling in the case at bar. In the first place, it involves principles of partnership law not applicable to our case. Moreover, the Lusthaus case involves factual determination by the Tax Court — the creation of a bona fide partnership — whereas our case involves a clear failure to apply fundamental legal principles.[19] In addition, while it may be reasonable and just to treat Mr. Lusthaus as substantially the owner of his wife's partnership interest, because she could not dispose of that interest without his consent (327 U. S., at page 296), it is not reasonable and just to treat Mr. Sunnen as substantially the owner of the royalty contracts which Mrs. Sunnen could freely sell, pledge, give away, or otherwise dispose of. Furthermore, we respectfully submit that the views expressed by Mr. Justice Reed,

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18 That *Commissioner v. Tower*, supra, applies primarily to cases of income earned by the personal efforts of the taxpayer, and not to income produced by property of another, is shown by: (a) *Canfield, C. L., v. Commissioner*, 7 T. C. 944, decided Oct. 11, 1946, acquiesced I. R. B. 1947-2, p. 1 (C. C. H. Decisions No. 15414); and (b) I. T. 3845, Par. 3 (b), 1947-7-12515 (p. 2), 474 C. C. H. Par. 6140, p. 10189. Cf. *Schreiber v. Commissioner*, 6 T. C. 707 (C. C. H. Decisions No. 15076), holding that wives were taxable upon rents received by them from a partnership, of which they were limited partners and their husbands were general and managing partners, for the use by the partnership of a building which had been purchased by the wives with their respective shares of the partnership profits. The Circuit Court of Appeals of the 6th Circuit affirmed this decision, *Schreiber v. Commissioner*, 160 Fed. 2d 108, stating that the Tax Court's decision conformed to the principles announced in *Commissioner v. Tower*, supra, and *Lusthaus v. Commissioner*, supra.

19 Our argument on this point is fully explained on p. 23 et seq. of Respondent's brief in opposition to petition for certiorari.

and approved by the Chief Justice, in the Lusthaus case[20], apply with greater force in our case because we are concerned with a gift valid beyond all question, and with income produced exclusively by property and not in large part by the personal efforts of one individual.

E. Term of Royalty Contracts.

In several places in petitioner's brief he emphasizes the fact that the royalty agreements were for periods of ten years.[21] This is done to cause this court to believe that Mr. Sunnen entered into a "short-term" arrangement similar in nature to the "short-term" family trust involved in the Clifford case. But the word "short" is relative. A trust for ten years may be for a short term because it could conceivably last for the lives of one or more persons. But ten years is not a short period in the seventeen-year life of a patent, especially when much of that seventeen-year period must be spent in making and perfecting the product, and creating a demand for it. Then, too, it often happens during such seventeen-year period that consumer demand is satisfied, or that a better product is made and marketed by others, or that infringement suits are brought and won

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20 See dissenting opinion in *Lusthaus v. Commissioner*, supra, rendered by Mr. Justice Reed, and joined in by the Chief Justice (327 U. S., at pages 297-304). *It should be noted, too, that while Mr. Lusthaus could undoubtedly have cancelled the partnership agreement by withdrawing from the partnership at will, could have entered into competing partnerships, could have insisted on bringing in new partners, or taken other steps affecting his wife's partnership income—all of which would have been similar in nature to the alleged powers of Mr. Sunnen so strongly stressed by petitioner in his brief—Mr. Justice Reed pointed out* (327 U. S., at page 303) *that "management of a business which involves only the risk of the capital of another is not the control to which the Clifford case refers."* Moreover, we also wish to point out that failure of the Sunnen royalty agreements to require payment of minimum royalties, a fact stressed by petitioner on page 18 of his brief, should be accorded no more importance than failure of the Lusthaus partnership agreement to require fixed payment to the partners, since it must be presumed that both agreements would, and could be required to be, performed in good faith.

21 For the sake of accuracy it should be noted that the renewal cylinder-grinder agreement was executed on January 10, 1938 and expired with the patent on December 4, 1951 (R. 28).

by others. We say, therefore, as did the Circuit Court of Appeals in the case at bar (R. 98-99), that these royalty contracts were not short-term arrangements, that their term does not affect the validity of the assignments as gifts, that their term is immaterial because no tax evasion motive can be shown, and that to hold otherwise requires repudiating or ignoring the fundamental law of assignments set forth above.

In addition, we wish to point out, as did the Board of Tax Appeals in regard to the assigned oil and gas leases involved in *Ray v. Commissioner*,[22] that these royalty agreements were wasting assets; that consequently as time expired, a period for exploitation was used, and was lost to all persons forever; and that the Clifford doctrine, which involves a temporary reallocation of family income, cannot be given effect in a situation which is not temporary because property rights are consumed, and can never revert to the grantor.[23]

F. **Dobson v. Commissioner**, 320 U. S. 489.

On page 22 of his brief petitioner now concedes that it is unnecessary to determine whether the decision of the Circuit Court of Appeals in the case at bar violated *Dobson v. Commissioner*, supra. Because of this concession it seems unnecessary for us to discuss the matter further. However, we do desire to point out that it seems inconsistent to prevent review of a Tax Court decision, under the ruling of the Dobson case, when the Tax Court's decision is diametrically opposed to a previous decision of the Board of Tax Appeals.

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22 *Ray, Rose L., v. Commissioner*, B. T. A. Memo. Decision Docket No. 101315, decided June 26, 1941, 1941 P-H, B. T. A. Memo Decisions para. 41325, C. C. H., B. T. A. Decisions No. 11874-a.

23 It should be noted, too, as evidence of Mr. Sunnen's intent to make "long-term" arrangements during the useful and productive life of the patents, that when the first cylinder grinder royalty agreement expired on January 10, 1938, it was immediately renewed for the life of the patent, and by Mr. Sunnen assigned to his wife (R. 28).

II.

THE DOCTRINE OF RES JUDICATA OR THE DOCTRINE OF STARE DECISIS SHOULD BE APPLIED.

A. 1937 Cylinder Grinder Royalties.

On page 26 of his brief petitioner says, "none of the royalty contracts and assignments now before the court were involved in the earlier case." This statement, which apparently forms the basis of petitioner's extended argument on the subject, is contrary to the stipulated facts (R. p. 27, par. 7; p. 30, par. 17).

The truth of the matter is that in 1937, one of the years here involved, Sunnen Products Company paid Mrs. Sunnen cylinder grinder royalties of $4,881.35 under the original cylinder-grinder royalty contract. This contract was executed on January 10, 1928; was assigned by Mr. Sunnen to his wife by writings dated January 8, 1929 and December 21, 1931, and expired on January 10, 1938. Royalties payable in previous years under the same identical written instruments were involved in Mr. Sunnen's prior case.

As to these royalties, both the Tax Court (R. 69-70) and the Circuit Court of Appeals (R. 99-100) held that the doctrine of res judicata is applicable.[24]

The petitioner, however, contends that such application of the doctrine of res judicata is erroneous. This is so, he claims, because in the interval between the two Sunnen decisions this court announced new principles of law in *Helvering v. Clifford*, supra; *Helvering v. Horst*, 311 U. S. 112; *Helvering v. Eubank*, 311 U. S. 122, and *Harrison v.*

[24] The Tax Court said (R. 70) that there was complete identity of issues and parties.

Schaffner, 312 U. S. 579. But the petitioner has not shown that such new principles of law have any application whatsoever to our case.

On the other hand, we have, we believe, shown that the Clifford case does not impose tax liability on Mr. Sunnen and that it enunciates no new principles regarding control applicable to him which were not fully expounded in *Corliss v. Bowers*, 281 U. S. 376, which was distinguished by the Board of Tax Appeals in Mr. Sunnen's prior case (R. 60). Nor do the Horst, Eubank and Schaffner cases impugn the principle, relied on in Mr. Sunnen's first case, that the owner of property is taxable upon the income produced thereby. This is clearly pointed out in *Pearce v. Commissioner*, 315 U. S. 543, 554, where this court said that the Horst, Eubank and Schaffner cases involved only assignments of income from property, and that the taxpayer had parted with no substantial interest in the property itself. Likewise, in *Helvering v. Stuart*, 317 U. S. 154, 168, this court said that in the Horst, Eubank and Schaffner cases the taxpayer had not really disposed of the res which produced the income.

Under these circumstances, we deny that any new legal principles, **applicable to the case at bar**, have intervened between the two Sunnen decisions.

B. **Other Royalties.**

In regard to the balance of the royalties paid to Mrs. Sunnen, under contracts not directly involved in Mr. Sunnen's prior case, the Tax Court held that the doctrine of res judicata was not applicable (R. 71). The Circuit Court of Appeals, in view of its decision for Mr. Sunnen on the merits, found it unnecessary to decide whether the doctrine of res judicata, or the doctrine of stare decisis, was

applicable, but did point out that the parties and the questions involved were the same in both of Mr. Sunnen's cases (R. 100-101). Such being the case, we contend that the doctrine of res judicata, or the more elastic doctrine of stare decisis,[25] is applicable.

In *Commissioner v. Montgomery*, supra, the Circuit Court of Appeals of the Fifth Circuit held that Montgomery was not the owner of profits from a construction contract assigned by him to his corporation. Despite this decision the Commissioner contended in *Montgomery v. Thomas*, supra, that Montgomery was the owner of income earned by the corporation on this contract and subsequently paid by it as dividends on stock owned by the Montgomery children. Nevertheless, the court applied the doctrine of res judicata, saying:

> "This court, in Commissioner v. Montgomery, considered and established the legality of the corporation and to whom its earnings belonged, and by whom the tax on its earnings was due. These questions were settled in that litigation between the same parties who are litigants here" (146 Fed. 2d, at page 79).

Likewise, we say that Mr. Sunnen's prior case established the separate entity of Sunnen Products Company, to whom its earnings belonged, and by whom the tax on such earnings is due. The case at bar merely represents a second attempt to have the courts again consider the same question. See, also, *City of Aurora v. West*, 74 U. S. (7 Wall.) 82, in which the Supreme Court said: "Where the parties are the same, the legal effect of the former judgment as a bar is not impaired, because the subject matter of the second suit is different, provided the second

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[25] See *Paul*, "*Selected Studies in Federal Taxation*," 2d Series, pp. 118, 119, pointing out that although these two doctrines are similar in some respects, the doctrine of stare decisis is more elastic and offers a binding rule of precedent in matters of law. See further 21 *Corpus Juris Secundum*, p. 305, and 14 American Jurisprudence, p. 283.

suit involves the same title, and depends upon the same questions." In *Last Chance Mining Company v. Tyler Mining Company*, 157 U. S. 683, 691, this court said: "The essence of the estoppel by judgment is that there has been a judicial determination of a fact, and the question always is, has there been such a determination, and not upon what evidence * * * it was reached." This language, and the statement made in *American Law Institute "Restatement of the Law—Judgments,"* p. 299, "Taxes," are particularly pertinent in connection with the factual determination, made in Mr. Sunnen's prior case, that the royalty contract constituted the income-producing property.

In addition we wish to point out that the doctrine of stare decisis applies even though the facts involved in the later case are not exactly the same as in the prior one. Thus in *Northwestern Mutual Life Ins. Co. v. Wright et al.*, 153 Wisc. 252, 140 N. W. 1078, American Annotated Cases 1914 D, pages 697, 699, 700, it is said:

> "An examination of the authorities cited by counsel for appellants does not enable us to find anything therein particularly out of harmony with the foregoing. In no one of them are the facts the same as those here, and, if there be anything said in any of them out of harmony with the principles stated, the principles, not the adjudication, must prevail. Every essential to a transfer of title, according to the terms of the assignment, is shown.
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> * * * * * * *
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> "It is quite useless to point out distinctions between a case in hand and previous adjudications here or elsewhere, there being no distinction in principle. The keynote of an adjudication is the ruling principle. The details showing the particular facts ruled by some particular principle are helpful; but in the end, it is the principle, not the detail circumstances, commonly evidentiary only, which is the important feature as to

whether an existing adjudication is a safe guide to follow in a case, presently. Mere details may widely vary, as indicated in the cases cited, yet the ruling principle be the same * * *."

See, also, *American Mutual Liability Ins. Co. of Boston v. Duesenberg*, 14 N. E. 2d 919, 16 N. E. 2d 698, 117 A. L. R. 1293, 1297, in which the Indiana Supreme Court said: "* * * but in the consideration of precedents courts do not look so much for identity of facts as for statements of applicable principles."

Consequently, we contend that, from the point of view of Mr. Sunnen's liability for income taxes on these royalties, there is no distinction in principle between this case and the prior case. Only some of the paper evidence is different.

III.

THE PETITIONER DID NOT ASSESS THE DEFICIENCIES FOR 1937 AND 1938 WITHIN THE TIME PRESCRIBED BY LAW.

On this point we concede that the deficiencies for 1937 and 1938 were assessed within due time by the Petitioner if this court should determine that he has borne the burden of proving that the royalties paid to Mrs. Sunnen in those years were owned by, and taxable to, Mr. Sunnen. We desire only to point out that the burden of proof in 1937 and 1938 is upon the Petitioner, because he is seeking to take advantage of the five-year limitation period mentioned in Sec. 275 (c) of the Revenue Acts of 1936 and 1938, 26 U. S. C. A., "Internal Revenue Acts," pp. 919, 1108. That the Commissioner must carry such burden of proof was established by *Easton v. Commissioner*, T. C. Memo. Op. Dkt. No. 110974, entered 2/5/43, 1 T. C. M. par. 12,963M, 1943 P-H T. C. Memo. Dec. Par. 43,063; *Burrows v. Com-*

missioner, T. C. Memo. Dec. Dkt. No. 109537, entered 6/30/43, 2 T. C. M. par. 13,350M, 1943 P-H T. C. Memo. Dec. Par. 43338; and *Reis v. Commissioner,* 1 T. C. 9.

Moreover, we contend that the Commissioner has not met the burden of proof placed upon him—has not established that said royalties were taxable to Joseph Sunnen; and that, consequently, his deficiency assessments for 1937 and 1938 are void because made after the time prescribed by Sec. 275 (a) of the Revenue Acts of 1936 and 1938.

Of course, if this court should hold that none of said royalties are taxable to Mr. Sunnen, then this question of limitation need not be passed upon.

CONCLUSION.

Based on these authorities we contend, on the first issue, that as Joseph Sunnen assigned to his wife the property which produced this income, he is not taxable thereon; that to tax him on it is to measure his income tax liability by the income of another, which is unconstitutional; that to tax him on it is to overlook the fact that he had no claim to such income, and could derive no gain, profit, or benefit therefrom; that he cannot be considered the virtual owner of said property, and of said income, under the Clifford doctrine, by merging his identity with that of Sunnen Products Company, or by merging his identity with that of Mrs. Sunnen; and that if the Commissioner's extension of the Clifford doctrine has any application to this case, it requires taxation of this income to Mrs. Sunnen, who had very important and substantial rights of ownership, and not to Mr. Sunnen, who had only an indirect, and legally nonexistent, power over Sunnen Products Company.

On the second issue, we believe that the decision in Mr. Sunnen's prior case barred the present deficiency assess-

ments, since that case held that he did not own the income, or the property which produced it.

And on the third issue, we contend that unless this court should determine that the Commissioner has borne the burden of proving that Mr. Sunnen was taxable upon the 1937 and 1938 royalties, the assessment of the deficiencies for such years was made after the expiration of the applicable statutes of limitation.

Respectfully submitted,

C. POWELL FORDYCE,
Attorney for Respondent.

APPENDIX.

Internal Revenue Act 1936:

Sec. 275. **Period of Limitation Upon Assessment and Collection.**

(a) **General rule.**—The amount of income taxes imposed by this title shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

Internal Revenue Act 1938:

Sec. 275. **Period of Limitation Upon Assessment and Collection.**

(a) **General rule.**—The amount of income taxes imposed by this title shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

Internal Revenue Act of 1936:

Sec. 275. **Period of Limitation Upon Assessment and Collection.**

(c) **Omission from gross income.**—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

Internal Revenue Act of 1938:

Sec. 275. **Period of Limitation Upon Assessment and Collection.**

(c) **Omission from gross income.**—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

SUPREME COURT OF THE UNITED STATES

No. 227.—October Term, 1947.

Commissioner of Internal Revenue, Petitioner, v. Joseph Sunnen.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[April 5, 1948.]

Mr. Justice Murphy delivered the opinion of the Court.

The problem of the federal income tax consequences of intra-family assignments of income is brought into focus again by this case.

The stipulated facts concern the taxable years 1937 to 1941, inclusive, and may be summarized as follows:

The respondent taxpayer was an inventor-patentee and the president of the Sunnen Products Company, a corporation engaged in the manufacture and sale of patented grinding machines and other tools. He held 89% or 1,780 out of a total of 2,000 shares of the outstanding stock of the corporation. His wife held 200 shares, the vice-president held 18 shares and two others connected with the corporation held one share each. The corporation's board of directors consisted of five members, including the taxpayer and his wife. This board was elected annually by the stockholders. A vote of three directors was required to take binding action.

The taxpayer had entered into several non-exclusive agreements whereby the corporation was licensed to manufacture and sell various devices on which he had applied

for patents.[1] In return, the corporation agreed to pay to the taxpayer a royalty equal to 10% of the gross sales price of the devices. These agreements did not require the corporation to manufacture and sell any particular number of devices; nor did they specify a minimum amount of royalties. Each party had the right to cancel the licenses, without liability, by giving the other party written notice of either six months or a year.[2] In the absence of cancellation, the agreements were to continue in force for ten years. The board of directors authorized the corporation to execute each of these contracts. No notices of cancellation were given. Two of the agreements were in effect throughout the taxable years 1937-1941, while the other two were in existence at all pertinent times after June 20, 1939.

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[1] The various devices involved were as follows:

(1) A cylinder grinder. The taxpayer applied for a patent on Nov. 17, 1927, and was issued one on Dec. 4, 1934. The royalty agreement to manufacture and sell this device was dated Jan. 10, 1928. This agreement expired on Jan. 10, 1938; a renewal agreement in substantially the same terms was then executed for the balance of the life of the patent, which ends on Dec. 4, 1951.

(2) A pinhole grinder. The taxpayer applied for a patent on Dec. 4, 1931, and was issued one on June 13, 1933. The royalty agreement to manufacture and sell this device was dated Dec. 5, 1931.

(3) A crankshaft grinder. The taxpayer applied for a patent on May 22, 1939, and was issued one on May 6, 1941. The royalty agreement to manufacture and sell this device was dated June 20, 1939.

(4) Another crankshaft grinder. The taxpayer applied for a patent on Dec. 29, 1939. He assigned this application to his wife on Dec. 29, 1942, and she was issued a patent on Jan. 26, 1943. The royalty agreement to manufacture and sell this device was dated June 20, 1939.

The taxpayer remained the owner of the first three patents throughout the year 1941, and he remained the owner of the patent application on the fourth device throughout that year.

[2] Six months' notice was provided in the agreement dated Jan. 10, 1928, covering the cylinder grinder. The other three agreements provided for one year's notice of cancellation.

The taxpayer at various times assigned to his wife all his right, title and interest in the various license contracts.[3] She was given exclusive title and power over the royalties accruing under these contracts. All the assignments were without consideration and were made as gifts to the wife, those occurring after 1932 being reported by the taxpayer for gift tax purposes. The corporation was notified of each assignment.

In 1937 the corporation, pursuant to this arrangement, paid the wife royalties in the amount of $4,881.35 on the license contract made in 1928; no other royalties on that contract were paid during the taxable years in question. The wife received royalties from other contracts totaling $15,518.68 in 1937, $17,318.80 in 1938, $25,243.77 in 1939, $50,492.50 in 1940, and $149,002.78 in 1941. She included all these payments in her income tax returns for those years, and the taxes she paid thereon have not been refunded.

Relying upon its own prior decision in *Estate of Dodson* v. *Commissioner*, 1 T. C. 416,[4] the Tax Court held that,

[3] On Jan. 8, 1929, the taxpayer assigned to his wife "all my rights, title and interest in and to the Royalty which shall accrue hereafter to me" upon the royalty contract of Jan. 10, 1928, with respect to the cylinder grinder device. Since the Commissioner of Internal Revenue raised some question as to the sufficiency and completeness of this assignment, the taxpayer executed a further assignment on Dec. 21, 1931. This second assignment confirmed the first one and stated further that his wife was assigned "all of my right, title and interest in and to said royalty contract of January 10, 1928 . . . . And I hereby state that the royalties accruing under said royalty contract have heretofore been and are hereafter the sole and exclusive property of the said Cornelia Sunnen [his wife], and hereby declare that said royalties shall be paid to the said Cornelia Sunnen or to her order, and that she shall have the sole right to collect, receive, receipt for, retain or sue for said royalties."

Assignments similar in form and substance to the assignment of Dec. 21, 1931, were made as to the other three royalty contracts.

[4] In the *Dodson* case, Dodson owned 51% of the stock of a corporation and his wife owned the other 49%. He was the owner of a

with one exception, all the royalties paid to the wife from 1937 to 1941 were part of the taxable income of the taxpayer. 6 T. C. 431. The one exception concerned the royalties of $4,881.35 paid in 1937 under the 1928 agreement. In an earlier proceeding in 1935, the Board of Tax Appeals dealt with the taxpayer's income tax liability for the years 1929–1931; it concluded that he was not taxable on the royalties paid to his wife during those years under the 1928 license agreement. This prior determination by the Board caused the Tax Court to apply the principle of *res judicata* to bar a different result as to the royalties paid pursuant to the same agreement during 1937.

The Tax Court's decision was affirmed in part and reversed in part by the Eighth Circuit Court of Appeals. 161 F. 2d 171. Approval was given to the Tax Court's application of the *res judicata* doctrine to exclude from the taxpayer's income the $4,881.35 in royalties paid in 1937 under the 1928 agreement. But to the extent that the taxpayer had been held taxable on royalties paid to his wife during the taxable years of 1937–1941, the decision was reversed on the theory that such payments were not income to him. Because of that conclusion, the Circuit Court of Appeals found it unnecessary to decide the taxpayer's additional claim that the *res judicata* doctrine applied as well to the other royalties (those accruing apart from the 1928 agreement) paid in the taxable years. We then brought the case here on certiorari, the Commis-

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formula and trade mark. Pursuant to a contract which he made with the corporation, the corporation was given the exclusive use of the formula and trade mark for 5 years, renewable for a like period. Dodson was to receive in return a royalty measured by a certain percentage of the net sales. He then assigned a one-half interest in the contract to his wife, retaining his full interest in the formula and trade mark. The Tax Court held that his dominant stock position permitted him to cancel or modify the contract at any time, thus rendering him taxable on the income flowing from his wife's share in the contract.

sioner alleging that the result below conflicts with prior decisions of this Court.

If the doctrine of *res judicata* is properly applicable so that all the royalty payments made during 1937–1941 are governed by the prior decision of the Board of Tax Appeals, the case may be disposed of without reaching the merits of the controversy. We accordingly cast our attention initially on that possibility, one that has been explored by the Tax Court and that has been fully argued by the parties before us.

It is first necessary to understand something of the recognized meaning and scope of *res judicata*, a doctrine judicial in origin. The general rule of *res judicata* applies to repetitious suits involving the same cause of action. It rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound "not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose." *Cromwell* v. *County of Sac*, 94 U. S. 351, 352. The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties upon any ground whatever, absent fraud or some other factor invalidating the judgment. See von Moschzisker, "Res Judicata," 38 Yale L. J. 299; Restatement of the Law of Judgments, §§ 47, 48.

But where the second action between the same parties is upon a different cause or demand, the principle of *res judicata* is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but "only as to those matters

in issue or points controverted, upon the determination of which the finding or verdict was rendered." *Cromwell* v. *County of Sac, supra,* 353. And see *Russell* v. *Place,* 94 U. S. 606; *Southern Pacific R. Co.* v. *United States,* 168 U. S. 1, 48; *Mercoid Corp.* v. *Mid-Continent Co.,* 320 U. S. 661, 671. Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, *res judicata* is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. See Restatement of the Law of Judgments, §§ 68, 69, 70; Scott, "Collateral Estoppel by Judgment," 56 Harv. L. Rev. 1.

These same concepts are applicable in the federal income tax field. Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is *res judicata* as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. Collateral estoppel operates, in other words, to relieve the government and the taxpayer of "redundant litigation of the identical question of the statute's application to the taxpayer's status." *Tait* v. *Western Md. R. Co.,* 289 U. S. 620, 624.

But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers of the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability, and a fertile basis for litigious confusion. Compare *United States* v. *Stone & Downer Co.*, 274 U. S. 225, 235–236. Such consequences, however, are neither necessitated nor justified by the principle of collateral estoppel. That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers.

And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. *Tait* v. *Western Md. R. Co.*, *supra*. If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation. See *Travelers Ins. Co.* v. *Commissioner*,

161 F. 2d 93. And where the situation is vitally altered between the time of the first judgment and the second, the prior determination is not conclusive. See *State Farm Ins. Co.* v. *Duel*, 324 U. S. 154, 162; 2 Freeman on Judgments (5th ed. 1925) § 713. As demonstrated by *Blair* v. *Commissioner*, 300 U. S. 5, 9, a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable.[5] But the intervening decision need not necessarily be that of a state court, as it was in the *Blair* case. While such a state court decision may be considered as having changed the facts for federal tax litigation purposes, a modification or growth in legal principles as enunciated in intervening decisions of this Court may also effect a significant change in the situation. Tax inequality can result as readily from neglecting legal modulations by this Court as from disregarding factual changes wrought by state courts. In either event, the supervening decision cannot justly be ignored by blind reliance upon the rule of collateral estoppel. *Henricksen* v. *Seward*, 135 F. 2d 986, 988–989; *Pelham Hall Co.* v. *Hassett*, 147 F. 2d 63, 68–69; *Commissioner* v. *Arundel-Brooks Concrete Corp.*, 152 F. 2d 225, 227; *Corrigan* v. *Commissioner*, 155 F. 2d 164, 165; and see *West Coast Life Ins. Co.* v. *Merced Irr. Dist.*, 114 F. 2d 654, 661–662; contra: *Commissioner* v. *Western Union Tel. Co.*, 141 F. 2d 774, 778. It naturally follows that an interposed alteration in the pertinent statutory provisions or Treasury regulations can make the use of

[5] See also *Henricksen* v. *Seward*, 135 F. 2d 986; *Monteith Bros. Co.* v. *United States*, 142 F. 2d 139; *Pelham Hall Co.* v. *Hassett*, 147 F. 2d 63; *Commissioner* v. *Arundel-Brooks Concrete Corp.*, 152 F. 2d 225; *Corrigan* v. *Commissioner*, 155 F. 2d 164. Compare *Grandview Dairy* v. *Jones*, 157 F. 2d 5.

that rule unwarranted. *Tait* v. *Western Md. R. Co.*, *supra*, 625.[6]

Of course, where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. See *The Evergreens* v. *Nunan*, 141 F. 2d 927. And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change. But if the relevant facts in the two cases are separable even though they be similar or identical, collateral estoppel does not govern the legal issues which recur in the second case.[7] Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. It may then reach a different result or, if consistency in decision is considered just and desirable, reliance may be placed upon the ordinary rule of *stare decisis*. Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment. *Tait* v. *Western Md. R. Co.*, *supra*. And see Griswold, "Res Judicata in Federal Tax Cases," 46 Yale L. J. 1320;

[6] And see *Commissioner* v. *Security-First Nat. Bank*, 148 F. 2d 937.

[7] *Stoddard* v. *Commissioner*, 141 F. 2d 76, 80; *Campana Corporation* v. *Harrison*, 135 F. 2d 334; *Engineer's Club of Philadelphia* v. *United States*, 42 F. Supp. 182.

Paul and Zimet, "Res Judicata in Federal Taxation," appearing in Paul, Selected Studies in Federal Taxation (2d series, 1938), p. 104.

It is readily apparent in this case that the royalty payments growing out of the license contracts which were not involved in the earlier action before the Board of Tax Appeals and which concerned different tax years are free from the effects of the collateral estoppel doctrine. That is true even though those contracts are identical in all important respects with the 1928 contract, the only one that was before the Board, and even though the issue as to those contracts is the same as that raised by the 1928 contract. For income tax purposes, what is decided as to one contract is not conclusive as to any other contract which is not then in issue, however similar or identical it may be. In this respect, the instant case thus differs vitally from *Tait* v. *Western Md. R. Co., supra,* where the two proceedings involved the same instruments and the same surrounding facts.

A more difficult problem is posed as to the $4,881.35 in royalties paid to the taxpayer's wife in 1937 under the 1928 contract. Here there is complete identity of facts, issues and parties as between the earlier Board proceeding and the instant one. The Commissioner claims, however, that legal principles developed in various intervening decisions of this Court have made plain the error of the Board's conclusion in the earlier proceeding, thus creating a situation like that involved in *Blair* v. *Commissioner, supra.* This change in the legal picture is said to have been brought about by such cases as *Helvering* v. *Clifford,* 309 U. S. 331; *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122; *Harrison* v. *Schaffner,* 312 U. S. 579; *Commissioner* v. *Tower,* 327 U. S. 280; and *Lusthaus* v. *Commissioner,* 327 U. S. 293. These cases all imposed income tax liability on transferors who had assigned or transferred various forms of income

to others within their family groups, although none specifically related to the assignment of patent license contracts between members of the same family. It must therefore be determined whether this *Clifford-Horst* line of cases represents an intervening legal development which is pertinent to the problem raised by the assignment of the 1928 agreement and which makes manifest the error of the result reached in 1935 by the Board. If that is the situation, the doctrine of collateral estoppel becomes inapplicable. A different result is then permissible as to the royalties paid in 1937 under the agreement in question. But to determine whether the *Clifford-Horst* series of cases has such an effect on the instant proceeding necessarily requires inquiry into the merits of the controversy growing out of the various contract assignments from the taxpayer to his wife. To that controversy we now turn.[8]

Had the taxpayer retained the various license contracts and assigned to his wife the right to receive the royalty payments accruing thereunder, such payments would clearly have been taxable income to him. It has long

[8] The pertinent statutory provisions are of little help to the matter in issue. Section 22 (a) of the Revenue Act of 1936, 49 Stat. 1648, and § 22 (a) of the Revenue Act of 1938, 52 Stat. 447, cover the taxable years in question. Those sections, which are identical with the current § 22 (a) of the Internal Revenue Code, define "gross income" to include "gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or for gains or profits and income derived from any source whatever." See also Art. 22 (a)–1 of Treasury Regulations 94, promulgated under the 1936 Act; Art. 22 (a)–1 of Treasury Regulations 101, promulgated under the 1938 Act; and § 19.22 (a)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code.

been established that the mere assignment of the right to receive income is not enough to insulate the assignor from income tax liability. *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136. As long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable. The problem here is whether any different result follows because the taxpayer assigned the underlying contracts to his wife in addition to giving her the right to receive the royalty payments.

It is the taxpayer's contention that the license contracts rather than the patents and the patent applications were the ultimate source of the royalty payments and constituted income-producing property, the assignment of which freed the taxpayer from further income tax liability. We deem it unnecessary, however, to meet that contention in this case. It is not enough to trace income to the property which is its true source, a matter which may become more metaphysical than legal. Nor is the tax problem with which we are concerned necessarily answered by the fact that such property, if it can be properly identified, has been assigned. The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes. As was said in *Corliss* v. *Bowers*, 281 U. S. 376, 378, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid."

It is in the realm of intra-family assignments and transfers that the *Clifford-Horst* line of cases has peculiar applicability. While specifically relating to short-term family trusts, the *Clifford* case makes clear that where the parties to a transfer are members of the same family group, special scrutiny is necessary "lest what is in reality but one economic unit be multiplied into two or more by

devices which, though valid under state law, are not conclusive so far as § 22 (a) is concerned." 309 U. S. at 335. That decision points out various kinds of documented and direct benefits which, if retained by the transferor of property, may cause him to remain taxable on the income therefrom. And it also recognizes that the fact that the parties are intimately related, causing the income to remain within the family group, may make the transfer give rise to informal and indirect benefits to the transferor so as to make it even more clear that it is just to tax him. Even more directly pertinent, however, is the *Horst* case, together with the accompanying *Eubank* case. See 2 Mertens, Law of Federal Income Taxation (1942), §§ 18.02, 18.14. It was there held that the control of the receipt of income, which causes an assignor of property to remain taxable, is not limited to situations where the assignee's realization of income depends upon the future rendition of services by the assignor. See *Lucas* v. *Earl, supra; Burnet* v. *Leininger, supra.* Such may also be the case where the assignor controls the receipt of income through acts or services preceding the transfer. Or it may be evidenced by the possibility of some subsequent act by the assignor, or some failure to act, causing the income or property to revert to him. Moreover, the *Horst* case recognizes that the assignor may realize income if he controls the disposition of that which he could have received himself and diverts payment from himself to the assignee as a means of procuring the satisfaction of his wants, the receipt of income by the assignee merely being the fruition of the assignor's economic gain.

In *Harrison* v. *Schaffner, supra,* 582, it was again emphasized that "one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid." And it was also

noted that "Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest in it, we have not allowed the form to obscure the reality." 312 U. S. at 583. *Commissioner* v. *Tower, supra,* and its companion case, *Lusthaus* v. *Commissioner, supra,* reiterated the various principles laid down in the earlier decisions and applied them to income arising from family partnerships.

The principles which have thus been recognized and developed by the *Clifford* and *Horst* cases, and those following them, are directly applicable to the transfer of patent license contracts between members of the same family. They are guideposts for those who seek to determine in a particular instance whether such an assignor retains sufficient control over the assigned contracts or over the receipt of income by the assignee to make it fair to impose income tax liability on him.

Moreover, the clarification and growth of these principles through the *Clifford-Horst* line of cases constitute, in our opinion, a sufficient change in the legal climate to render inapplicable, in the instant proceeding, the doctrine of collateral estoppel relative to the assignment of the 1928 contract. True, these cases did not originate the concept that an assignor is taxable if he retains control over the assigned property or power to defeat the receipt of income by the assignee. But they gave much added emphasis and substance to that concept, making it more suited to meet the "attenuated subtleties" created by taxpayers. So substantial was the amplification of this concept as to justify a reconsideration of earlier Tax Court decisions reached without the benefit of the expanded notions, decisions which are now sought to be perpetuated regardless of their present correctness. Thus in the earlier litigation in 1935, the Board of Tax Appeals was unable to bring to bear on the assignment of the

1928 contract the full breadth of the ideas enunciated in the *Clifford-Horst* series of cases. And, as we shall see, a proper application of the principles as there developed might well have produced a different result, such as was reached by the Tax Court in this case in regard to the assignments of the other contracts. Under those circumstances collateral estoppel should not have been used by the Tax Court in the instant proceeding to perpetuate the 1935 viewpoint of the assignment.

The initial determination of whether the assignment of the various contracts rendered the taxpayer immune from income tax liability was one to be made by the Tax Court. That is the agency designated by law to find and examine the facts and to draw conclusions as to whether a particular assignment left the assignor with substantial control over the assigned property, or the income which accrues to the assignee. And it is well established that its decision is to be respected on appeal if firmly grounded in the evidence and if consistent with the law. *Commissioner* v. *Scottish American Co.*, 323 U. S. 119; *Dobson* v. *Commissioner*, 320 U. S. 489. That is the standard, therefore, for measuring the propriety of the Tax Court's decision on the merits of the controversy in this case.

The facts relative to the assignments of the contracts are undisputed. As to the legal foundation of the Tax Court's judgment on the tax consequences of the assignments, we are unable to say that its inferences and conclusions from those facts are unreasonable in the light of the pertinent statutory or administrative provisions or that they are inconsistent with any of the principles enunciated in the *Clifford-Horst* line of cases. Indeed, due regard for those principles leads one inescapably to the Tax Court's result. The taxpayer's purported assignment to his wife of the various license contracts may properly be said to have left him with something more

than a memory. He retained very substantial interests in the contracts themselves, as well as power to control the payment of royalties to his wife, thereby satisfying the various criteria of taxability set forth in the *Clifford-Horst* group of cases. That fact is demonstrated by the following considerations:

(1) As president, director and owner of 89% of the stock of the corporation, the taxpayer remained in a position to exercise extensive control over the license contracts after assigning them to his wife. The contracts all provided that either party might cancel without liability upon giving the required notice. This gave the taxpayer, in his dominant position in the corporation, power to procure the cancellation of the contracts in their entirety. That power was nonetheless substantial because the taxpayer had but one of the three directors' votes necessary to sanction such action by the corporation. Should a majority of the directors prove unamenable to his desires, the frustration would last no longer than the date of the next annual election of directors by the stockholders, an election which the taxpayer could control by reason of his extensive stock holdings. The wife, as assignee and as a party to contracts expressly terminable by the corporation without liability, could not prevent cancellation provided that the necessary notice was given.

And it is not necessary to assume that such cancellation would amount to a fraud on the corporation, a fraud which could be enjoined or otherwise prevented. Cancellation conceivably could occur because the taxpayer and his corporation were ready to make new license contracts on terms more favorable to the corporation, in which case no fraud would necessarily be present. All that we are concerned with here is the power to procure cancellation, not with the possibility that such power might be abused. And once it is evident that such power exists, the conclusion is unavoidable that the taxpayer retained a sub-

stantial interest in the license contracts which he assigned.

(2) The taxpayer's controlling position in the corporation also permitted him to regulate the amount of royalties payable to his wife. The contracts specified no minimum royalties and did not bind the corporation to manufacture and sell any particular number of devices. Hence, by controlling the production and sales policies of the corporation, the taxpayer was able to increase or lower the royalties; or he could stop those royalties completely by eliminating the manufacture of the devices covered by the royalties without cancelling the contracts.

(3) The taxpayer remained the owner of the patents and the patent applications. Since the licenses which he gave the corporation were non-exclusive in nature, there was nothing to prevent him from licensing other firms to exploit his patents, thereby diverting some or all of the royalties from his wife.

(4) There is absent any indication that the transfer of the contracts effected any substantial change in the taxpayer's economic status. Despite the assignments, the license contracts and the royalty payments accruing thereunder remained within the taxpayer's intimate family group. He was able to enjoy, at least indirectly, the benefits received by his wife. And when that fact is added to the legal controls which he retained over the contracts and the royalties, it can fairly be said that the taxpayer retained the substance of all the rights which he had prior to the assignments. See *Helvering* v. *Clifford*, *supra*, 335–336.

These factors make reasonable the Tax Court's conclusion that the assignments of the license contracts merely involved a transfer of the right to receive income rather than a complete disposition of all the taxpayer's interest in the contracts and the royalties. The existence

of the taxpayer's power to terminate those contracts and to regulate the amount of the royalties rendered ineffective for tax purposes his attempt to dispose of the contracts and royalties. The transactions were simply a reallocation of income within the family group, a reallocation which did not shift the incidence of income tax liability.

The judgment below must therefore be reversed and the case remanded for such further proceedings as may be necessary in light of this opinion.

Reversed.

MR. JUSTICE FRANKFURTER and MR. JUSTICE JACKSON believe the judgment of the Tax Court is based on substantial evidence and is consistent with the law, and would affirm that judgment for reasons stated in *Dobson* v. *Commissioner*, 320 U. S. 489, and *Commissioner* v. *Scottish American Co.*, 323 U. S. 119.